Declining „Common" Agricultural Policy? CAP Reform of 2003 and its National Implementation in the Member States

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Abstract

This paper focuses on the basic element of the 2003 CAP reform process: on the single farm payment and its national implementation models. . We examine possible economic impacts (production distorting effects, redistribution, restructuring, resource allocation and effects on land market) of the basic SFP models. In sum, we can say that the 2003 CAP reform and the new support provide an opportunity to overcome some of the difficulties the CAP faces with. However, the wide range of national diversities threatens the principle of the single market, and transparency and operation of the common market organizations. As there is a wide range of possible constructions member states can decide for, the common nature of the CAP gets more and more questionable.

Keywords: CAP reform, decoupling, single farm payment

JEL classification: Q17, Q18, F13, F15

1 Introduction

Common Agricultural Policy (CAP) of the European Union (EU) has been a very important building block of the European integration. However, after a spectacular development it has become a neuralgic are of the integration. In order to overcome the difficulties a significant reform process began in 1992. Despite of the significant changes, however, the pressure on the system of the CAP has not stopped. With the 2003 reform decisions we have arrived to the third phase of the reform process, and this phase provides an opportunity to overcome some of the difficulties. (However, there remains a lot to be done.)

Measures agreed by the Council in June 2003, envisage a basic reform of the Common Agricultural Policy (CAP) through which the European Union (EU) made a significant step in the direction of a more transparent and less trade distorting agricultural policy. Our paper focuses on the basic element of the reform process: on the single farm payment and its national implementation models. The 2003 CAP reforms have provided a large space for national manoeuvre. The following elements of the reform fall within national competence: possibility of partial decoupling; determination of the date of introduction (2005-2007); limited freedom to select the single farm payment (SFP) calculation model (historic, regional or hybrid); re-allocation a part of the support through the national envelope.

Therefore, instead of a simplification of the support system, different de-coupling models, and the possibility of partial de-coupling have resulted in a very complex system with a wide range of national diversities. It is interesting then to examine the economic impacts of the new direct income support system. The second part of our paper overviews the most important features of the new support system and outlines the basic models of calculating the single farm payment. Possible economic impacts (production distorting effects, redistribution, restructuring, resource allocation and effects on land market) of the basic SFP models are discussed in part three. Part four summarizes the main effects of the 2003 CAP reform.

2 Basic models of calculating the single farm payment

The most radical feature of the June 2003 CAP reform agreement is the decoupling of subsidies from production and their replacement by one farm payment, known as the Single Farm Payment (SFP). The new payments are based on reference data, and because of the already compulsory cross-compliance, they are available only on condition that certain environmental, animal welfare food security and quality standards are met. Through the instrument of modulation member countries can reduce the SFP for bigger farms up to 5 percent in order to finance additional rural development measures. If the CAP budget threatens to exceed the budget ceilings agreed in October 2002, a new financial discipline can be invoked to scale down payments.

Decoupling has been made less strict than the European Commission originally proposed. Member states can choose for a delay of its introduction until 2007 instead of 2005. More important, member states are enabled to limit decoupling of income payments for a number of products, as they have the possibility to maintain a proportion of coupled policies (See Table 1).

Table 1: Maximum rate of coupled support, selected products

Supported product	Maximum rate of coupled support (%)
Cereals and oilseeds	25
Rice	42
Protein crops (supplementary)	100
Sheep	50
Beef	
Option 1	40
Slaughter Premium	100
Suckler Cow Premium	
Option 2	100
Slaughter Premium	
Option 3	75
Special Beef Premium	

As a new element the 2003 CAP reforms have provided a large space for national manoeuvre. The following elements of the reform fall within national competence:

- possibility of partial decoupling;
- determination of the date of introduction (2005-2007);
- re-allocation a part of the support through the national envelope;
- limited freedom to select the single farm payment (SFP) calculation model (historic, regional or hybrid).

As regards the SFP model there are two basic approaches. The *historic model* creates entitlements to support based on the average level of subsidies claimed in the livestock and arable sectors during the 2000-2002 reference period. The number of entitlements allocated to each farmer is set equal to the average area of land giving rise to subsidy plus all pasture land during that same period. The value of each of these entitlements is established by dividing the average amount of subsidy claimed by the farmer by the number of entitlements awarded.

The *regional (area based) model* operates by basing entitlements to farmers on the area of eligible land that they declare in their 2005 Integrated Administration and Control Scheme (IACS) returns. The value of all entitlements within a region would be set at a single, common rate. However, it is possible to create a third approach to decoupling by combining the historic and regional approaches into what is termed a *hybrid model*. This can be done in different ways to create various

forms of hybrid. However, there are two broad hybrid classes – *horizontal* and *vertical*. A horizontal hybrid is created by putting a set proportion of the decoupled budget arising from each coupled regime into a regional element, with the balance of the budget allocated according to historical claims patterns. A vertical hybrid is created by putting specific coupled schemes, or proportions thereof, into the area-based component, with the balance allocated according to historical claims patterns. Also the ratio of regional and historical elements of hybrid models can vary in later years. If the ratios do not change in the future the model is static, while if the model incorporates changing ratios the model is dynamic. Models chosen by member states are summarized in Table 2.

Table 2: National implementation models

	Historical	Regional	Static hybrid	Dynamic hybrid
Maximum possible coupling	F			
Partial decoupling	A, B, GR, I, NL, P, E, GB (Scotland)	M, SLO	DK, S	SF, D
"Full" decoupling	IRL, GB (Wales)		L, GB (NIRL)	GB (England)

Source: Halmai, 2004

As Table 2 shows SFP is applied not only in the 15 "old" member states but also in two new member states, and there are four different models in the United Kingdom (England, Scotland, Wales and Northern Ireland). There is also a small difference between the implementation models of Flandreau and Vilonia in Belgium. As you can see the chosen constructions are very different. Full decoupling is only applied in a part of the United Kingdom, in Northern Ireland and in Luxemburg.

3 Certain economic impacts of the basic SFP models

3.1 Production distortions

Economic impact of the various decoupling models depends mainly on the level the decoupled payment effects production decisions. The 2003 CAP reform constitutes a major change in the way direct payments are made in the EU. The introduction of the SFP results in a reduction in the link between the payments and production. Findings of the OECD PEM analysis (2003a) show that payments based on acreage are the most decoupled category. In that way they have no or at most minimal trade and production distorting effects. Furthermore, the impact of such payments is all the lower where there is no obligation to grow specific crops on eligible land in order to receive the support. SFP meets both criteria, however, the regional system meets better the criteria than the historical system based on former subsidy types (and on their distortions). Modelling the producers' production decisions also the results of the OECD's AGLINK model show that the SFP's influence is minimal (OECD, 2004).

As OECD (2002) suggests policy reform should be eased by evidence of a win-win relationship between the income transfer efficiency of domestic policies and their tendency to distort trade. According to this work there is a strong inverse correlation between the extent to which a measure distorts production and trade, and its efficiency in transferring income benefits to those who farm. Put simply, the more a policy pays to a farmer without affecting production decisions, the greater the share of income retained by the household and the smaller the impact on production and trade. Both the results of the PEM analysis (OECD, 2005) and analysis on transfer efficiency (OECD, 2002) suggest that the SFP seems to be an efficient choice. It is efficient as it provides only minimal distortions and can meet the simultaneous requirement of income support of domestic producers and minimal distortions with the smallest cost. SFP meets all of the above mentioned criteria, however, the regional system meets them better than the historical system based on former subsidy types (and on their distortions).

3.2 Redistribution effects

A change in a support model is inevitably accompanied by *redistribution effects*: there will be winners and losers of the new system. In case of the historical model redistribution effect may occur in the beef sector. Significant part of the special beef and extensification premium got back from the fattener to the veal keeper in the old (coupled) system. Decoupling breaks down this transfer mechanism. In case of the historical model fatteners may realize an unexpected benefit, while veal breeders will suffer a loss. Transfer of resources comes about inside the sector.

In the regional system transfer of resources between sectors is also possible. This system favours the more extensive farms with a net transfer from intensive farms. (For details see DEFRA, 2003a.) The regional system has more beneficiaries and provides opportunity to redistribute the resources between regions and sectors.

Producers get different amount of support per hectare in the historical model, even in the case of neighbouring farms. (Unit value of the support entitlement is different from farm to farm.) However, producers' commitments, the need to meet the criteria of cross compliance, are the same for all of them. Different level of support in exchange for the same standards could be a source of future conflicts. The regional system (based on average areas) seems to be more rational from this point of view. However, the level of area based subsidy in a region has been calculated on the basis of the former level of coupled payments and not on the basis of private costs of cross compliance and of providing public goods.

Table 3: Effects of decoupling models

<table>
<tr><th rowspan="2">Effects</th><th rowspan="2">Historical</th><th rowspan="2">Regional</th><th colspan="2">Hybrid</th></tr>
<tr><th>Horizontal</th><th>Vertical</th></tr>
<tr><td>Former distortions</td><td>May have effect</td><td>More limited effects</td><td colspan="2">Limited effects</td></tr>
<tr><td rowspan="3">Redistribution</td><td rowspan="3">Limited resource transfer inside a sector (e.g.: beef)</td><td rowspan="3">Strong redistribution effects between sectors and regions. Suitable for the reduction of difference in support levels</td><td colspan="2">Ratio of different components can influence</td></tr>
<tr><td>If the ratio of the regional component is high, it is similar to the regional system</td><td>Provides opportunity to tone the effects</td></tr>
<tr><td colspan="2">Supports transition (transitional hybrid)</td></tr>
<tr><td>Dispersion of the value of support entitlements</td><td>High, different levels per farm</td><td>No (single value per farm in the region)</td><td colspan="2">Reduces dispersion (negative correlation with the ratio of regional component)</td></tr>
<tr><td>Winners and losers (relative to the former system)</td><td>No change (except for beef)</td><td>Favours the more extensive farms</td><td>Similar to the regional, but the effects are not so significant and can be influenced</td><td>Similar to the horizontal, but there are more opportunity to tone the effects</td></tr>
<tr><td>Possible shock (due to the change in the support system)</td><td>No (except for veal sector)</td><td>Unexpected gains, unexpected losses</td><td colspan="2">Milder than in case of a regional system</td></tr>
</table>

Source: Halmai, 2004

Distortions of the basic models can be reduced by a hybrid model. As regards its impacts, the *horizontal hybrid* model stands between the two basic models. Model results (DEFRA, 2003a) show that: the larger is the ratio of the regional component, the larger is the redistribution effect relative to the historical model.

Vertical hybrids also provide an opportunity to fine tone the basic models. (E.g.: it gives more rational results for the beef sector relative to the historical model. See: DEFRA, 2003b.) However, targeting of decoupled subsidies seems to be a paradox. It can be applied only on the short term in order to prevent shocks arising after the change of the support system. On the mid- and longer term market actors adjust to the changes, they can alter their production practice or they can enter other sectors. Therefore, targeted hybrids can be applied only in support of transition. (The main effects are summarized in Table 3.)

3.3 Restructuring and resource allocation

A fully decoupled support does not influence the producers' production decisions. Structure of production depends exclusively on the relative profitability of different products. Production should cover at least the variable costs.

In these circumstances *restructuring may accelerate*. Unprofitable units may abandon production as they will get the single farm payment even without production. Competitive units however, may acquire resources of the former actors (land, animals, farm buildings etc.). A system which is fixed for several years in advance improves the anticipation of market actors and creates better investment environment. Consequently *resource allocation could be more effective*.

However, full decoupling may have strong negative effects in certain (mainly marginal or socio-economically sensitive) areas. France was the most important antagonist of full decoupling, but also Great Britain (one of the most important supporters of radical reforms) stressed that full decoupling may result in depopulation of rural areas or in a transition to a ranch-type farming in certain areas. Undesirable social consequences may arise (Agra Europe, 19th September 2003).

In fact, the new system may be accompanied by a strong reduction of expenditures and more extensive structures can be expected. Marginal areas could be compensated through the second pillar of the CAP (rural development measures). (Wide ranging instruments comprise adjustment related investment subsidies, agri-environment and forestry programs etc.)

An important element of the implementation is the *possibility of partial decoupling* in case of certain subsidies. As you can see in Part 2 member states have opted for different options ranging from full decoupling to the maximum possible level of coupling (see Table 2). Most of the member states retained some coupled support. However, *disadvantages of partial decoupling* are very important: it continues to prevent production adjusting to market signals and it raises production above the optimal level distorting agricultural markets and at the same time, slows structural change down.

Through partial decoupling member states want to avoid sudden changes in production. Therefore, allocation efficiency improves only to a limited extent on the short term. *On the medium term degree of decoupling and efficiency of allocation can increase.*

It was expected that single farm payment brings a significant simplification of the support system. However, different de-coupling models, and the possibility of partial de-coupling have resulted in a *very complex system with a wide range of national diversities*. Severe problems may arise during the implementation and control of the system. The wide range of national diversities threatens the principle of the single market, and transparency and operation of the common market organizations.

3.3 Possible effects on land and lease markets

Single farm payment is based on agricultural area. As its amount is significantly higher than that of the former area based payments, it *can theoretically raise the price and rental cost of land*.

The system favours mainly the landowners. When landowners cultivate themselves their land it is really the producer who realizes the support. However, if a prospective farmer purchases the land he has to pay not only for the market value of the land, but also the net present value of the future transfers. What is more, when the land is rented then the tenant conveys much of the support to the landowner.

The above described effects may be different depending upon the selected model of decoupling. The *traditional model* may strengthen the position of tenants, as the amount of support entitlements is based on past agricultural performance (land cultivated, number of animals etc.). After the contracted period the tenant may activate its support entitlement on other areas, while the landowner is compelled to let the land by lease without support entitlement. In this case the rise in land prices is limited, what is more *land prices may even reduce*.

In the regionalized system the number of entitlements is based on the total area of arable and grass land reported in the year of introduction. All the farmers (including also the tenants) working on these areas can (and certainly will) apply for the single farm payment. *The amount of the support will then capitalize mainly in land prices and rent fees.* This is inconsistent with a basic principle of the reform, with the aim of strengthening the position of producers (instead of landowners). This principle is especially important for the new member states (with often highly complicated landownership system), which however, are compelled to apply this regionalized system.

The different hybrid models can moderate the possible negative effects of the regionalized system.

4 Possible impacts of the 2003 CAP reform. (Summing up remarks)

Similarly to the earlier reform steps the decisions of the 2003 CAP reform were significantly less radical than the Commission originally proposed. As regards the construction of the reform the following compromises should be stressed.

- *Partial decoupling.* Full decoupling of direct payments from production was the central element of the Commission's January 2003 proposal. The approved decisions however, foresee only partial decoupling.
- *Modulation.* In contrast to the originally proposed digressive reduction a linear system was approved which provides opportunity only for a limited reallocation of funds. Reallocation of the modulated support is based on rather complex rules.
- *Cross-compliance.* The range of standards which should be met in order to be eligible for the single farm payment is narrower than the Commission proposed. However, problems may arise during the control even of this limited range of standards. The fact that – due to the special structure of the support system – meeting the same standards makes producers eligible for different sum of support can be a source of allocation problem.
- *National divergences.* The system based on partial decoupling will be very complicated. Significantly different models will be implemented. Implementation and control of all the systems both can cause significant difficulties. Wide ranging national divergences threaten the principle of single market and therefore transparency and operation of the common market organizations.

– *Financial disciplines.* The automatism designed to prevent the overspending is more rigorous than the former stabilization systems. When it comes into operation single farm payment can be curtailed significantly. This mechanism brings uncertainty into the economic environment of farming. In contrast to the originally proposed digressive system of dynamic modulation the reduction of the support is linear, so it creates proportional burden for producers with different farm sizes.

Despite of the above mentioned compromises implementation of the 2003 CAP reform may bring significant changes to the operational environment of the CAP.

Market coordination becomes more important and the competitive pressure increases. Reform decisions will significantly alter the CAP's operation mechanism. Decisive part of direct payments will be decoupled. Payments will not influence farmers' production decisions. As a main rule, the single farm payment does not have effect on production structure. Competition between different market actors may become more intensive, and so do the pressure for return. However, the possibility of partial decoupling may mitigate these effects as it limits the adjustment to market signals. Production in that way may continue to exceed the market demand.

Reduction of overproduction and increasing competitiveness can be expected. The reform will be accompanied with significant market effects, particularly in the dairy and beef sectors. (These effects however, differ significantly under the different national implementation alternatives.) Because of reduction in milk and dairy prices, declining surplus and the increase of competitiveness can be expected. Overproduction in the beef sector decreases significantly, prices will increase after an initial downturn and profitability improves. This process will supported by the fact that import protection continues to be high. Due to the rise in efficiency competitiveness improves not only the domestic markets. After a possible reform in the sugar sector, surpluses can further reduce. Dynamism of agricultural markets can be even stronger for the EU-25. New member states gradually exploit their possibilities. Market of the EU-25 will be characterized by improving competitiveness and stronger pressure for efficiency.

There will be important *redistribution effects*. An important objective of the reform is to improve the allocation and gradually enforcement of multifunctional aspects. Modulation will somewhat lessen the support of large farms. However the approved system foresees more restricted income reallocation than originally proposed. (Modulation will affect only 1.16 billion euro instead of the originally proposed 3.5 billion euro.) Reallocation of these resources can theoretically favour the less developed countries. Modulation however, will not reverse the fact that the larger part of support will be allocated to large farms of which efficiency and profitability is more favourable than that of the smaller ones. Reallocation effect of models chosen for national implementation of the single farm payment can be significant. Regionalisation could result in strong evening: it would put massive burden on farms which are more intensive and at the same time, would favour the more extensive ones. (Effects of hybrid models, which are more or less based on regions, could be similar.)

Structural change, more efficient resource allocation. The on-going reforms could somewhat reduce the ratio of animal breeding in the production structure. The most unprofitable part of it will be forced to leave the market. (This process will be accelerated by decupling of support.) Sugar market reform could result in a decreasing sugar production. Production of plants could decline on marginal areas and extensification becomes more important. As regards the farm structure, significance of competitive aspects will increase. Structural change can accelerate. Activity of non-competitive units drives back: reduction of expenditure results in a more extensive structure, the rural activity possibly focuses exclusively on the maintenance of landscape. Competitive units can acquire physical resources of actors losing their market. Depending on the level of decoupling a more efficient system of resource allocation could be the result.

Decreasing cost of land and/or declining land prices? Decoupled nature of the single farm payment may affect costs and prices of land. The increasing sum of area based support can theoretically boost land prices. However, because of the system of cross compliance, beneficiaries are bound to provide certain (environmental etc.) services. Expenditure of these additional services and

other conditions of the support can also influence the costs of land. These effects are different in the various models of decoupling. The model based on historical entitlements may strengthen the position of tenants, as the value of entitlements is based on individual performance (area cultivated, number of animals etc.) of former periods. However, if the ratio of areas without entitlements is small, possibilities of tenants are limited. If the support is allocated exclusively based on areas, all the arable and grass land is entitled for the support which is determined as a regional average. The support will than capitalise in land prices rental fees. (Depending on the elements chosen, hybrid models are between the two basic models.) At the same time, there will be market for support entitlements.

Limited rural development possibilities. Effects accelerating structural change and the adjustment pressure would require expanding investment, training and market development programs. At the same time more activity would be required in agri-enviornment and rural development. However, the reform does not result in a significant rise of rural development funds.

Decreasing level of support? Due to the tight budgetary frames a support decreasing mechanism may start to operate from 2007. Besides the modulation this mechanism can also reduce the sum of the single farm payment. The tight budgetary frames may prevent rural development to evolve. At the same time they can also strengthen the trends pushing for re-nationalization.

5 Concluding remarks

The most radical feature of the June 2003 CAP reform agreement is the decoupling of subsidies from production and their replacement by one farm payment, known as the single farm payment. It was expected that single farm payment brings a significant simplification of the support system. However, different de-coupling models, and the possibility of partial de-coupling have resulted in a very complex system with a wide range of national diversities. Severe problems may arise during the implementation and control of the system.

Economic impact of the various decoupling models depends mainly on the level the decoupled payment effects *production* decisions. The 2003 CAP reform constitutes a major change in the way direct payments are made in the EU. The introduction of the SFP results in a reduction in the link between the payments and production. Also the findings of the OECD's works (2003, 2004, 2005) show that single farm payment has no or at most minimal trade and production distorting effects.

A change in a support model is inevitably accompanied by *redistribution effects*: there will be winners and losers of the new system. In case of the historical model beef breeders may realize an unexpected benefit, while veal keepers will suffer a loss. Transfer of resources comes about inside the sector. In the regional system however, transfer of resources between sectors is also possible. This system favours the more extensive farms.

A fully decoupled support does not influence the producers' production decisions. Structure of production depends exclusively on the relative profitability of different products. In these circumstances *restructuring may accelerate* and *resource allocation could become more effective*. However, *partial decoupling* continues to prevent production adjusting to market signals and it raises production above the optimal level distorting agricultural markets and at the same time, slows structural change down.

Single farm payment is based on agricultural area. As its amount is significantly higher than that of the former area based payments, it *can theoretically raise the price and rental cost of land*. The *traditional model* may strengthen the position of tenants. In this case the rise in land prices is limited, what is more *land prices may even reduce*. *In the regionalized system however, the amount of the support will capitalize mainly in land prices and rent fees.*

Despite of the above mentioned deficiencies and difficulties 2003 CAP reform may bring significant changes to the operational environment of the CAP: market coordination becomes more important and the competitive pressure increases; reduction of overproduction and increasing competitiveness can be expected; there will be important redistribution effects; structural change, more

efficient resource allocation; possibly decreasing cost of land and/or declining land prices; possibly decreasing level of support.

In sum, we can say that the 2003 CAP reform and the new support provide an opportunity to overcome some of the difficulties the CAP faces with. However, the wide range of national diversities (as a consequence of the newly introduced measures) threatens the principle of the single market, and transparency and operation of the common market organizations. As there is a wide range of possible constructions member states can decide for, the common nature of the CAP gets more and more questionable.

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